

Letter of Findings Number: 07-0260
Sales and Use Tax
For the Tax Years 2004 - 2005

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ISSUES

I. Sales and Use Tax – Manufacturing Exemption.

Authority: IC § 6-8.1-5-1(c); IC § 6-2.5-2-1; IC § 6-2.5-3-2(a); IC § 6-2.5-1-24; IC § 6-2.5-5-3(b); [45 IAC 2.2-5-8\(c\)\(d\)](#); Sales Tax Information Bulletin 8 (May, 2002); *Indiana Dep't of State Revenue v. Interstate Warehousing*, 783 N.E.2d 248 (Ind. 2003); *Rotation Products Corp. v. Dep't of State Revenue*, 690 N.E.2d 795 (Ind. Tax Ct. 1998).

The Taxpayer protests the imposition of use tax on an uncoiler and a slitter.

II. Sales and Use Tax – Imposition of Use Tax on Packaging Materials.

Authority: IC § 6-2.5-3-3; IC § 6-2.5-3-2(a); IC § 6-2.5-3-1(b); IC § 6-2.5-4-2(b)(1); IC § 6-2.5-4-1; IC § 6-2.5-5-1; [45 IAC 2.2-5-16](#) (c)(1); *Miles, Inc. v. Dep't of State Revenue*, 659 N.E.2d 1158 (Ind. Tax Ct. 1995).

The Taxpayer protests the imposition of use tax on a slitter.

III. Tax Administration - Ten Percent Negligence Penalty.

Authority: IC § 6-8.1-10-2.1; [45 IAC 15-11-2\(b\)\(c\)](#).

The Taxpayer protests the imposition of the ten percent negligence penalty.

STATEMENT OF FACTS

The Taxpayer makes rolls of steel suitable for manufacturing by trimming off the mill edges. The Taxpayer receives steel coils from steel mills. The Taxpayer owns a portion of the steel it receives and processes. The remainder of the steel is owned by the steel mills, processed by the Taxpayer, and sold by the steel mill to customers desiring the processed steel. After an audit, the Indiana Department of Revenue assessed additional use tax, interest, and penalty for the tax years 2004 and 2005. The Taxpayer protested a portion of the use tax assessment and the penalty. A hearing was held and this Letter of Findings results.

I. Sales and Use Tax – Manufacturing Exemption.

DISCUSSION

The Department assessed use tax on the Taxpayer's purchase of repair parts, supplies, and related equipment for both the uncoiler and the slitter during the tax years 2004-2005 pursuant to IC § 6-2.5-3-2(a). The Taxpayer protested this assessment. The Taxpayer argued that the uncoiler, the slitter, their repair parts, supplies, and related equipment qualified for the manufacturing exemption found at IC § 6-2.5-5-3(b).

The issue to be determined is whether or not the uncoiler and the slitter qualify for the manufacturing exemption from the use tax. Each machine will be considered separately.

All tax assessments are presumed to be valid. IC § 6-8.1-5-1(c). The Taxpayer bears the burden of proving that any assessment is incorrect. *Id.* Exemption statutes are to be strictly construed against taxpayers. *Indiana Dep't of State Revenue v. Interstate Warehousing*, 783 N.E.2d 248, 250 (Ind. 2003).

Indiana imposes a sales tax on the transfer of tangible personal property in a retail transaction. IC § 6-2.5-2-1. Indiana imposes a complementary excise tax, the use tax, on tangible personal property stored, used, or consumed in Indiana. IC § 6-2.5-3-2(a). IC § 6-2.5-5-3(b) provides for an exemption for tangible personal property directly used in the direct production of the Taxpayer's product for sale. This manufacturing exemption is further described at [45 IAC 2.2-5-8\(c\)](#) as follows:

The state gross retail tax does not apply to purchases of manufacturing machinery, tools and equipment to be directly used by the purchaser in the production process, provided such machinery, tools and equipment are directly used in the production process; i.e., they have an immediate effect on the article being produced. Property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which produces tangible personal property.

Pre-production and post-production activities are defined at [45 IAC 2.2-5-8\(d\)](#) as follows:

"Direct use in the production process" begins at the point of the first operation or activity constituting part of the integrated production process and ends at the point that the production has altered the item to its completed form, including packaging, if required.

After receipt from the steel mill, the rolled steel is placed into an uncoiler. This machine unrolls the steel so it is flat and can be fed into the slitter. Although it is necessary to unroll the steel to feed it into the slitter, the uncoiler does not change the steel in anyway. The uncoiler operates prior to the first point where the steel is actually changed in the integrated production process. Therefore the uncoiler is not an essential and integral part of the production process for purposes of the manufacturing exemption from use tax. The uncoiler, its repair parts,

its supplies, and its related equipment do not qualify for the manufacturing exemption pursuant to IC § 6-2.5-5-3(b).

The slitter alters the steel by cutting off the mill edges. After this alteration, the Taxpayer sells its product, the trimmed steel, to manufacturers for use in the manufacturing of other tangible personal property. The operation of the slitter has an immediate effect on the product being produced – the trimmed steel. The slitter's operation on steel owned by the Taxpayer which the Taxpayer produces for resale qualifies for the manufacturing exemption pursuant to IC § 6-2.5-5-3(b). Any repair parts, supplies, and equipment related to the slitter's operation on steel owned by the Taxpayer also qualify for the exemption. In 2004, the Taxpayer owned 76 percent of the steel which it trimmed. In 2005, the Taxpayer owned 65 percent of the steel which it trimmed. Thus, 76 percent of the repair parts, supplies, and equipment related to the slitter's operation in 2004 qualifies for the manufacturing exemption. 65 percent of the repair parts, supplies, and equipment related to the slitter's operation in 2005 qualifies for the manufacturing exemption.

The Taxpayer does not own the remainder of the steel which the slitter trims. These steel coils are owned by the steel mills during the entire time the coils of steel are at the Taxpayer's facility including when the slitter is trimming the steel coils. The steel mills sell the processed steel coils to the mills' customers. Since the Taxpayer does not own the steel, the Taxpayer is providing the service of trimming the mill ends off the steel coils for the owners, the steel mills. There is no exemption from the sales or use tax for the use of property in the provision of a service.

The Taxpayer argues that its process of trimming steel is in actuality a production process producing a marketable good. Since its process is a production process producing a marketable product, the Taxpayer argues that the manufacturing exemption to sales and use tax applies. In support of its contention, the Taxpayer cites the case *Rotation Products Corp. v. Dep't of State Revenue*, 690 N.E.2d 795 (Ind. Tax Ct. 1998). In that case, the Rotation Products Corporation reworked ball bearings. The court found that Rotation Products Corporation's reworking of the ball bearings constituted a production process producing a marketable product. Therefore, the manufacturing exemption applied to the equipment used to remanufacture the ball bearings. The Taxpayer argues that its provision of services to steel owned by others – the slitter's actions of trimming the steel – similarly constitutes a production process producing a marketable product. Therefore, the slitter would also qualify for the manufacturing exemption when it acted upon steel that was not owned by the Taxpayer.

The *Rotation Products* case sets out four requirements that must be met for the provision of a service to be considered a production process producing a marketable product. The first of the requirements is that the service provider performs substantial and complex work that changes the remanufactured product in a significant manner. In the *Rotation Products* case, the company removed and discarded ball bearing cages, ground and polished the ball bearings, and produced new rolling elements and cages. The Taxpayer's process merely trims the edges of the steel. This does not rise to the standard of significant and substantial change required for exemption by the *Rotation Products* case. The second of the *Rotation Products* case requirements is that the service be provided to remanufacture a useless and worthless item. In the *Rotation Products* case, the roller bearings were so worn that they were useless with no market value. The owner of the bearings only had two options, throw the ball bearings away or have them remanufactured in a process like the *Rotation Products* remanufacturing process. The Taxpayer's service is trimming steel that belongs to the steel mills. The steel which the Taxpayer trims is not worthless and useless since it has a market value.

Since the Taxpayer's process does not meet the first two requirements for exemption as set out in the *Rotation Products* case, it is unnecessary to examine the remaining two requirements. The Taxpayer's process of trimming steel belonging to others is a service rather than a production process. Therefore the repair parts, supplies, and related equipment purchased for the slitters for the percentage of time that the slitter is used to process steel not owned by the Taxpayer does not qualify for the manufacturing exemption found at IC § 6-2.5-5-3(b).

Finally, the Taxpayer argues that the Department's assessment violates provisions of both the United States and Indiana Constitutions. An administrative hearing is not the proper forum to consider the constitutionality of a state tax issue.

FINDING

The Taxpayer's protest to the assessment of use tax on repair parts, supplies, and related equipment for the uncoiler is denied. The Taxpayer's protest to the assessment of use tax on the 76 percent of repair parts, supplies, and equipment related to the slitter for 2004 is sustained. The Taxpayer's protest to the assessment of use tax on the 65 percent of repair parts, supplies, and equipment related to the slitter for 2005 is sustained. The remainder of the Taxpayer's protest to the use tax on repair parts, supplies and equipment related to the slitter operation is denied.

II. Sales and Use Tax – Imposition of Use Tax on Packaging Materials.

The Department assessed use tax on the packaging and wrapping materials the Taxpayer used to wrap the processed steel belonging to the steel mills. These materials included strapping, donuts, pads, chipboard, and wrap. The Taxpayer protested this assessment arguing that the packaging materials should be granted exemption as directly used in direct production pursuant to IC § 6-2.5-5-3. In its clarification of the manufacturing exemption,

[45 IAC 2.2-5-16](#) (c)(1) provides that "[N]onreturnable containers and wrapping materials including steel strap and shipping pallets to be used by the purchaser as enclosures for selling tangible personal property' qualify for exemption from the gross retail tax." The Taxpayer does not sell the processed steel that the wrapping materials enclose. Therefore, the wrapping materials do not qualify for the manufacturing exemption provided at IC § 6-2.5-5-3.

Alternatively, the Taxpayer argues that it did not use the packaging materials in Indiana. IC § 6-2.5-3-2(a) imposes the use tax on "the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction." "Storage" is defined at IC § 6-2.5-3-1(b) as, the keeping or retention of tangible personal property in Indiana for any purpose except the *subsequent use of that property solely outside Indiana.* (*emphasis added.*)

The Taxpayer argues that the packaging materials are used by the out-of-state customers of the steel mills. Therefore, the Taxpayer's use of the materials is limited to storage for subsequent use outside the state. The Taxpayer cites *Miles, Inc. v. Dep't of State Revenue*, 659 N.E.2d 1158 (Ind. Tax Ct. 1995) in support of its contention. In that case, the court found that Miles merely stored in Indiana for use outside the state the paper information statements included in the bottles. This is entirely different from the Taxpayer's situation. The Taxpayer's wrapping materials secure the steel to the trucks or trains transporting the steel through Indiana en route to the out-of-state customers of the steel mills. Since the wrapping materials are actually used in Indiana, they are subject to the use tax.

The Taxpayer also argues that it sells the packaging materials to the steel mills. Therefore, they qualify for the purchased for resale exemption. A transaction is considered an exempt wholesale transaction if the seller makes a transaction prescribed at [IC 6-2.5-4-2\(b\)\(1\)](#) as follows:

Sells tangible personal property, other than capital assets or depreciable property, to a person who purchases the property for the purpose of reselling it without changing its form;

For the packaging materials to qualify for exemption as a purchase for resale, the Taxpayer would have to meet the statutory description of "selling at retail" as stated at IC § 6-2.5-4-1(b) as follows:

A person is engaged in selling at retail when, in the ordinary course of his regularly conducted trade or business, he:

- (1) acquires tangible personal property for the purpose of resale; and
- (2) transfers that property to another person for consideration

The Taxpayer claims that it resells the packaging materials to its customers, the steel mills. The Taxpayer did not provide any evidence documenting that the steel mills paid consideration for the packaging materials. The Taxpayer did not establish that it was in the regular business of selling wrapping materials rather than the processing of steel. It is not even in the regular business of selling the subject rolls of steel since they are owned by the steel mills during the entire process and the steel mills sell them to their customers. The Taxpayer does not qualify for the purchase for resale exemption from the use tax.

Additionally, the Taxpayer argues that the wrapping straps, donuts, and pads qualify for exemption as tangible personal property consumed in the production process pursuant to IC § 6-2.5-5-5.1. It has already been determined that the process by which the Taxpayer trims steel belonging to steel mills is the provision of a service rather than a production process. The consumption in the production process requires a production process in which the property is consumed. Since there is no production process in this situation, the exemption provided at IC § 6-2.5-5-1 does not apply.

Finally, the Taxpayer argues that the Department's assessment violates provisions of both the United States and Indiana Constitutions. An administrative hearing is not the proper forum to consider the constitutionality of a state tax issue.

FINDING

The Taxpayer's protest to the imposition of use tax on wrapping materials is denied.

III. Tax Administration - Ten Percent Negligence Penalty

DISCUSSION

The Taxpayer protests the imposition of the ten percent negligence penalty pursuant to IC § 6-8.1-10-2.1. Indiana Regulation [45 IAC 15-11-2](#)(b) clarifies the standard for the imposition of the negligence penalty as follows:

Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

The standard for waiving the negligence penalty is given at [45 IAC 15-11-2\(c\)](#) as follows:

The department shall waive the negligence penalty imposed under [IC 6-8.1-10-1](#) if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause,

the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:

- (1) the nature of the tax involved;
- (2) judicial precedents set by Indiana courts;
- (3) judicial precedents established in jurisdictions outside Indiana;
- (4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc;
- (5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.

Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

The Taxpayer provided substantial documentation to indicate that its failure to pay the assessed use tax was due to reasonable cause rather than negligence.

FINDING

The Taxpayer's protest to the imposition of the penalty is sustained.

CONCLUSION

The Taxpayer's protest to the assessment of use tax on repair parts, supplies, and related equipment for the uncoiler is denied. The Taxpayer's protest to the assessment of use tax on the 76 percent of repair parts, supplies, and equipment related to the slitter for 2004 is sustained. The Taxpayer's protest to the assessment of use tax on the 65 percent of repair parts, supplies, and equipment related to the slitter for 2005 is sustained. The remainder of the Taxpayer's protest to the use tax on repair parts, supplies and equipment related to the slitter operation is denied. The Taxpayer's protest to the imposition of use tax on wrapping materials is denied. The Taxpayer's protest to the imposition of the penalty is sustained.

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